No. 19923

IN THE

United States Court of Appeals For the Ninth Circuit

DICKMAN LUMBER COMPANY,
a Washington corporation,
Appellant,

v.

UNITED STATES OF AMERICA,
Appellee.

APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF WASHINGTON, SOUTHERN DIVISION

HONORABLE GEORGE H. BOLDT, *Judge*

REPLY BRIEF OF APPELLANT

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SUBJECT INDEX*

*Table of Abbreviations
Record—R.
Reporter's Transcript—R. Tr.
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APPELLEE'S COUNTER-STATEMENT OF THE CASE

In its counter-statement of the case, the appellee, as did the District Court in its oral decision and findings, omitted and ignored facts which were material to the plaintiff's case and which were established by the undisputed evidence. Such material facts, which are for the most part established from the matters set forth in plaintiff's Exhibit 2 and other exhibits which were admitted into evidence, on stipulation, from the deposition of R. L. Dickman, Sr., who was unable to appear in Court by reason of physical disability, and whose testimony

was taken on written interrogatories and cross-interrogatories, and from the underscored portions of the affidavit of Donald L. Doud (R. 172), which were admitted by the appellee (R. 179) are set forth as follows:

(1) Large purchases or negotiations for purchases of private and state timber on non-scale lump sum cash basis (Ex. 2).

(2) Loans made or arranged for in bidding on or purchasing at such non-scale lump sum cash sales (Ex. 9; Dep. 40, 41).

(3) Competition in purchase of federal and state timber intensified by Japanese exports (R. Tr. 59-61, 192, 200).

(4) Due to the rapidly diminishing and depleted timber supply, the continued existence of the appellant required that it purchase all available timber suitable for its mill which could be acquired at a price which would produce a profit (Dep. 28; R. 167, 168).

(5) Ratio of Douglas fir upon which appellant depends for profitable production of specialties, to hemlock and related species of timber, progressively decreasing (Ex. 2; Dep. 29).

(6) Adequate supply of Douglas fir logs for appellant's operations unobtainable on the open market (Ex. 2; Dep. 29, 30).

(7) Annual dollar log requirement of appellant consisting of one-half fir and one-half hemlock amounts to the approximate sum of $1,500,000.00 (Dep. 25).

(8) Progressive increase in cost of stumpage and of log production at appellant's mill (Dep. 24).

(9) Volatile and fluctuating prices on lumber products produced by appellant (Ex. 4).

(10) Statements of appellant's officers of reasons for not declaring larger dividend at end of 1959 in overcoming presumption that appellant corporation

was availed of for the purpose of avoiding taxes on its shareholders (Dep. 38, 39; R. Tr. 70, 71).

(11) No assessment of accumulated earnings tax until 1959, although appellant's income tax returns for previous years showed large profits and comparable liquidity and were audited each year (R. Tr. 206-211).

Even though the appellee's counter-statement of the case is strictly limited to the findings made by the District Court (R. 180-190), certain statements are made which cannot stand unchallenged since such statements are incomplete and inaccurate. Thus, we find on page 8 of appellee's brief "The December 31, 1959, holdings of logs and timber were in excess of taxpayer's one-year capacity for the production of lumber." The evidence will not support the appellee's asserted inference that a one-year supply of logs and timber was sufficient to assure the appellant's continued existence with an ever-increasing and undiminishing supply of raw materials. As a matter of fact, the undisputed evidence discloses that the appellant should acquire all logs and timber within its means which would be suitable for its mill and could be purchased at a price which would produce a profit (Dep. 28). The Berry Creek No. 3 sale appellee refers to as having a potential of 19,400,000 feet of timber at the end of 1959, as a matter of fact produced only 13,728,030 feet of logs B.M. with an underrun of 5,671,970 feet B.M. (Ex. 13). Again, on page 9 of appellee's brief, it is stated that the loss sustained by appellant in 1958 amounted to the sum of $590,491.00,

which was largely due to the Fernandez log and timber purchase transactions, but that the appellant's uncollectible judgment against Fernandez was written off in 1958 for tax purposes and resulted in a higher over-all loss for 1958. Then appears the following language on page 10:

> "This substantial loss, therefore, was not for the most part a reflection of normal operations, but was due to one extraordinary situation."

The actual Fernandez bad debt loss allowed in 1958 amounted to the sum of $462,000.00 (R. St. 156), and resulted in a total loss for that year, as adjusted by the Internal Revenue Service, of $590,491.00. Under such adjustment the appellant had a net operating loss in 1958 of $128,491.00. Any portion of this operating loss allocated to depreciation was on the "straight line depreciation basis" since the "accelerated depreciation method" was not adopted until 1961 (R. Tr. 138).

On page 10 of its brief, the appellee attempts to minimize the losses sustained by the taxpayer for the years 1960, 1961 and 1962, as shown by the income tax returns, by setting forth the depreciation deductions, the amount of the salaries payable to R. L. Dickman, Sr., and his son, R. L. Dickman, II, for each of said years, and it is further stated that there was an outstanding balance of $30,934.94 in advances to officers, and an accrued income tax claim receivable of $308,278.75 for the year 1960. The Fernandez and Kelly bad debt write-

offs in the sum of $84,355.75 in the year 1962 are also set forth in minimizing the 1962 income tax losses.

The depreciation, salaries and bad debt write-offs were approved in the income tax audit for each of the three years in question as proper deductions under the Internal Revenue Code and Regulations. At the end of 1959, the advances to officers were limited to the sum of $9,192.00 and at said time the officers of the corporation had no knowledge of the income tax receivable in the sum of $308,278.75 since the Fernandez 1958 bad debt loss was not approved or agreed to by the Internal Revenue Service until the issue of the agent's report dated October 21, 1961. The sum of $30,934.94, which is stated to be the total amount of the advances to officers at the end of 1960, were debts due the corporation from the officers and were evidenced by promissory notes (R. Tr. 110, 111).

SUMMARY OF REPLY TO ARGUMENT OF APPELLEE

This reply is directed to the five following issues raised by the appellee's answering brief:

I. Review of entire record foreclosed under "clearly erroneous rule."

II. Liquidity of appellant.

III. That appellant could obtain all logs required from the open log market and from purchase of state and federal timber on installment payment basis.

IV. That the retirement of stock under Section 303

was personal to the Dickmans and did not constitute a corporate need; and

V. That appellant has not questioned or overcome presumption that the corporation was availed of to avoid income tax on shareholders.

I.

Review of Entire Record Not Foreclosed Under "Clearly Erroneous Rule"

On page 20 of its brief, under the subtitle "Standard of Review," the appellee sets forth the general principle that, "unless the District Court's findings, including its inferences from undisputed facts, are clearly erroneous or induced by an erroneous view of the law, they must be upheld." The case of *Commissioner v. Duberstein,* 363 U. S. 278, 80 S. Ct. 1190, 4 L.Ed.2d 1218 (1960), is cited, together with other authorities in support of this rule.

The appellant asserts two grounds in support of its contention that there should be a review of the entire record. First, the District Court, in its oral decision and findings, omitted and ignored facts which were established by the undisputed evidence and which were material to the appellant's case, as shown on pages 2-3 of this brief. Second, the District Court failed and neglected to find the facts specially and state the conclusions of law with clarity in its memorandum decision as required under Rule 52(a) Fed. Rules of Civ. Proc. In this connection, we again refer to the case of *Roberts v. Ross,* (3 C.A. 1965) 344 F.2d 747, cited in appellant's

opening brief, which states that the findings and conclusions as set forth in the lower court's memorandum decision must be sufficient to indicate the basis of the Judge's decision.

The most casual reading of the District Court's oral decision (R. 198) will disclose that it not only deals with broad generalizations which are vague and not particularly germane to the issues involved, but that there is a failure to make specific findings on all of the material facts covered by the evidence in the case. The nearest approach to a specific finding as required under Rule 52(a) are the statements that the cash assets and accumulated earnings in prior years were sufficient to meet the reasonable needs of the business and that "the evidence does not preponderate to show that there was a reasonable business necessity for retaining the $129,000 odd portion of earnings retained in 1959."

In connection with the appellant's contention which was urged throughout the proceedings that the accumulation of earnings to pay federal estate and inheritance taxes, etc., was a reasonable need of the business, the District Court stated:

> "However, I want to make it plain I am not deciding as a matter of fact or law whether the estate tax requirements justify the earnings retention in question in whole or in part." (R. 201).

It should be borne in mind that the only change made in the original findings submitted by the appellee (R. 115), was the incorporation by reference on page 1 of

the Court's findings finally entered (R. 180) of the Court's memorandum decision. The quoted portion is clearly inconsistent with Finding 25 (R. 188) in which it is stated that the redemption of stock under Sec. 303 served no corporate purpose and indicated a purpose to accumulate earnings and profits in 1959 in excess of those reasonably needed in order to avoid income tax on its shareholders. From these inconsistent statements it is difficult to determine just what the Court finds or concludes on the Section 303 question. These inconsistencies certainly constitute an ambiguity and are in violation of the duties of a trier of the facts under Rule 52(a) as outlined in the case of *Roberts v. Ross, supra.*

With respect to the duties of the trier of the facts, in making specific findings under Rule 52(a), the contrast should be noted between the detailed and specific findings made by the District Court in the case of *Cummins Diesel Sales of Oregon, Inc., v. United States,* as reported in 207 F. Supp. 246, and the lower court's memorandum decision in this case. The Circuit Court of Appeals for the Ninth Circuit affirmed the lower court's decision under the "clearly erroneous rule" in *Diesel Sales of Oregon, Inc., v. United States,* 321 F.2d 503, and the appellee strongly relies on this case in support of this contention that there should be no review of the entire record, but that the Circuit Court's inquiry should be limited to the Court's memorandum decision and the findings of fact and conclusions of law as entered by the

Court. In support of its position the appellee has also cited the case of *Commissioner v. Duberstein, supra.* In this decision there was a consolidation of two cases, both of which required a determination of whether a transfer of property was a gift excludable from the recipient's gross income for income tax purposes. The second case (No. 546) involved a cash payment by a church to the taxpayer upon his resignation from a church office. The District Court as the trier of fact made only the simple and unelaborated finding that the transfer in question was a "gift." The Supreme Court held that this finding was insufficient and the case was remanded to the District Court for further finding. Language from the *Duberstein* case is quoted in the footnote.[1]

II.

Liquidity Factor

From an examination of the Court's oral decision (R.

1. "To four of us, it is critical here that the District Court as trier of fact made only the simple and unelaborated finding that the transfer in question was a 'gift.' To be sure, conciseness is to be strived for, and prolixity avoided, in findings; but, to the four of us, there comes a point where findings become so sparse and conclusory as to give no revelation of what the District Court's concept of the determining facts and legal standards may be. See *Matton Oil Transfer Corp. v. The Dynamic* (CA 2 NY) 123 F.2d 999-1001. Such conclusory, general findings do not constitute compliance with Rule 52's direction to 'find the facts specially and state separately . . . conclusions of law thereon.' While the standard of law in this area is not a complex one, we four think the unelaborated finding of ultimate fact here cannot stand as a fulfillment of these requirements. It affords the reviewing court not the semblance of an indication of the legal standard with which the trier of fact has approached his task. For all that appears, the District Court may have viewed the form of the resolution or the simple absence of legal consideration as conclusive. While the judgment of the Court of Appeals cannot stand, the four of us think there must be further proceedings in the District Court looking toward new and adequate findings of fact." (363 U.S. 292, 4 L.Ed.2d 1229)

198), it is obvious that, after stating that it would not make either a finding of fact or conclusion of law on appellant's contention that the accumulation for the retirement of stock under Section 303 was a reasonable need of the business, the Court rendered its decision on the sole ground that appellant had sufficient liquid assets at the end of 1958 to take care of the reasonable needs of the business, and that that part of the 1959 net earnings in the sum of $129,031.12 which constituted the base upon which the accumulated earnings tax was assessed, was not required for such reasonable needs and should have been declared as dividends.

Since the District Court's decision, the United States Circuit Court of Appeals for the Second Circuit has handed down a decision in the case of *Electric Regulator Corporation v. CIR*, (2 C.A. 1964) 336 F.2d 339, which it is urged is applicable to the liquidity question. In that case the corporate taxpayer, which manufactured electric control devices, was organized in 1945 by the two principal shareholders, with an original total investment limited to the sum of $2,180.00. From the time of its organization up to the time of the assessment of the accumulated earnings tax for the years 1957 and 1958, taxpayer had expended considerable sums of money in the expansion of its plant. During the twelve years of its existence, the taxpayer had acquired assets totaling more than $1,000,000.00 and during all of its existence had never paid a cash dividend. Current assets and lia-

bilities for the years 1957 and 1958 were as follows:

1957	Current Assets	$1,219,292.00
	Current Liabilities	600,569.00
1958	Current Assets	864,104.00
	Current Liabilities	252,240.00

The earned surplus from 1955 through 1959 was as follows:

1955	$474,139.00
1956	532,663.00
1957	754,191.00
1958	848,006.00
1959	932,026.00

The combined salaries of the two principal shareholders and officers of the corporation, namely, the President and Treasurer, for the years 1955 through 1959, were as follows:

1955	$ 51,000.00
1956	94,915.02
1957	108,500.00
1958	90,011.92
1959	78,380.42

The only loans to shareholders were made in 1957 and 1958 and were limited to $3,000.00. The taxpayer had never sustained losses from the time it commenced business. The future prospects for sales and profits were good. The Commissioner of Internal Revenue assessed an accumulated earnings tax in the sum of $81,751.01 for 1957 and $25,944.69 for 1958.

Taxpayer paid the taxes and sued for a refund in the Tax Court which held in *Electric Regulator Corporation*

v. CIR (N.Y. 1963), 40 U.S.T.C. 757, in favor of the Commissioner. The decision was based largely on Section 1.535-3(b)(ii) of the Internal Revenue Regulations. A quotation from the decision is set forth in footnote.[2]

The U. S. Court of Appeals for the Second Circuit reversed the Tax Court on the two following principal grounds: First, the Company's earned surplus had been converted into improvements, machinery, equipment and inventory and was not available for current expenses to say nothing of dividends and, for that reason, was not subject to the tax. Second, the Company had no more cash on hand than was adequate since, in this day of technological change, specific sums cannot always be earmarked or set aside in advance to achieve a specific goal. Language from the decision of the Second Circuit is set forth in the footnote.[3]

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2. "Thus it will be seen that, if the earnings and profits of the current year are required to be retained for the reasonable needs of the business, this may provide a possible shield against the imposition of the accumulated earnings tax. But on the other hand, if the reasonable needs of the business can be satisfied from the earnings and profits already accumulated in prior years, there is no necessity for retaining any portion of the current year's earnings and profits to satisfy such needs. Hence, if that is true the earnings and profits of the current year may be found to be accumulated beyond the reasonable needs of the business, and the right to any credit based upon the reasonable needs of the business may be destroyed.

From what has been said above, it is at once apparent that the size of the accumulated earnings and profits from prior years (often called earned surplus or simply surplus) is an important factor. Yet such surplus cannot be viewed in isolation." (40 USTC 765)

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3. "In addition to finding that accumulated earnings and profits provided a sufficient 'cushion' for present and future needs, the Tax Court concluded that petitioner had adequate cash with which to pay out all of its 1957 and 1958 net earnings in dividends. We conclude that this holding was also clearly erroneous. Again, it is apparent that balance sheet totals rarely, if ever, tell the whole story. Only after close analysis

of the nature of the cash account and the present and anticipated demands which it will be forced to meet, can a trier of fact venture a finding that the liquid assets justify the declaration of a dividend. Nothing in the Internal Revenue Code prohibits large cash balances where the taxpayer has sufficient need for the cash in its business. Although it maintained a cash account of substantial magnitude, the evidence is plain that petitioner's needs for cash were real and that any accumulation was fully justified. ° ° °"

° ° °

"Petitioner's rapid and well-managed growth in a highly competitive industry hardly presents the picture of a tax-saving device. Its earnings have not been allowed to lie fallow; rather, they have been plowed back into the corporation in the form of new plant and other income producing assets. It has developed new product lines and actively sought to expand its markets, compare *Smoot Sand & Gravel Corp. v. Commissioner, supra,* 274 F.2d at 497-98."

° ° °

"If the Tax Court's views here were to be accepted, they would give to the Treasury virtually absolute power to stifle or encourage economic growth as it—not the corporate directors—decided how each company should handle its corporate and financial affairs. The Courts are not unmindful of the efforts of the Department of Justice through its Anti-Trust Division to encourage competition by attacking monopolistic practices which might be harmful to smaller units of industry, and of Congress' decided interest in small business and its development. It would be anomalous indeed were the Treasury to have the power to thwart these praiseworthy objectives. But equally praiseworthy is (and should be) the Treasury's vigilance lest a corporation, particularly a private or family-owned corporation with only a few stockholders, be used to prevent the imposition of high taxes on such stockholders."

"To resolve this possible conflict, a careful examination of the facts of each case must be made. The circumstances in a number of cases decided by this Court in recent years are markedly different from those found here. In *The Factories Investment Corp. v. Commissioner,* 328 F.2d 781 [13 AFTR2d 880] (2d Cir., 1964) neither dividends nor salaries were ever paid. In *Oyster Shell Prods. Corp. v. Commissioner,* 313 F.2d 449 [11 AFTR2d 777] (2d Cir., 1963) loans were made to shareholders, and investments were made in the stock of unrelated corporations. In *Youngs Rubber Corp. v. Commissioner,* T.C. Memo, 1962-300, aff'd, 331 F.2d 12 [13 AFTR2d 1251] (2d Cir., 1964) large reserves were kept accumulated for personal, not corporate, purposes and moneys were set aside for specific uses which never materialized. On the other hand in *R. Gsell & Co., supra,* the need for the accumulation was obvious."

"Mindful of the possibility of the misuse of the corporate form and the careful examination which must be made when no dividends have been declared by those in control of a closely-owned corporation, we have, under these facts, no hesitancy in declaring our 'definite and firm conviction' that the Tax Court was in error in concluding that Petitioner was availed of for the prohibited purpose. See *United States v. U. S. Gypsum Co.,* 333 U.S. 364, 394, 68 S. Ct. 625, 92 L.Ed. 746 (1947)." (336 F.2d 344-346)

In comparing the facts of the *Electric Regulator Corporation* case with the instant case, the following differences should be noted and given the proper weight: In the *Electric Regulator* case, there had never been a declaration of cash dividends. In the instant case the plaintiff had declared and paid dividends over the years as recognized by the District Court's Finding No. 12 (R. 183). In the cited case the combined salaries of the two principal shareholders and officers of the corporation, namely, the President and Treasurer, was the sum of $108,500.00 for the year 1957, and the sum of $90,-011.92 for the year 1958, the two years for which the accumulated earnings tax was assessed. Here, the combined salaries of the two principal shareholders and officers of the corporation for the year 1959 was limited to the sum of $47,000.00, of which amount R. L. Dickman, Sr., received $30,000.00 and his son, R. L. Dickman, II, received $17,000.00. In this connection it must be borne in mind that the appellant was a much larger corporation than the Electric Regulator Corporation, both from the standpoint of book value of assets and the dollar value of raw materials processed, as well as volume of manufactured products and manufacturing and sales activities. While the loans to shareholders in the cited case was limited to the sum of $3,000.00, the loans to the two principal shareholders and officers of the Dickman Lumber Company only amounted to $9,192.00 in 1959. The Electric Regulator Corporation never sustained a loss during the twelve-year period of existence,

while here the appellant corporation had sustained losses for the years 1958, 1960, 1961 and 1962. In comparing the facts of the two cases, it is further pointed out that in the *Electric Regulator* case the future outlook for increased profits and sales was most optimistic. In this case the future prospects for profitable operations are decidedly doubtful.

Since the entry of the judgment by the District Court in the instant case, the three following cases which have been decided by the Tax Court are applicable to this issue:

John P. Scripps Newspapers (Filed 6/25/65)
44 T. C. 41

Freedom Newspapers, Inc. (Filed 9/15/65)
T. C. Memo 1965-248

Bremerton Sun Publishing (Filed 7/16/65)
44 T. C. 53

On page 338 of the *John P. Scripps Newspapers* case, *supra,* and at page 420 in the *Bremerton Sun Publishing* case, *supra,* the Tax Court resorts to the same language as quoted below in discussing the rule of thumb doctrine which has been employed by the courts in determining whether a corporation's working capital requirements are sufficient to meet its needs.[4]

4. "As an aid in determining whether a corporation's working capital requirements are sufficient to meet its needs, resort has been had to certain general 'rules of thumb.' It has been held that a ratio of current assets to current liabilities which is in the neighborhood of 2½ to 1 is an indication of a reasonable accumulation of surplus. *John P. Scripps Newspapers, supra.* Cf. *R. C. Tway Coal Sales Co. v. United States,* 3 F. Supp. 668 (12 AFTR 1073) (W.D.Ky. 1933) affd. 75 F.2d 336 (15 AFTR 189) (C.A. 6, 1935); *Sandy Estate Co.,* 43 T.C. 361 (1964);

The problems in *Freedom Newspapers, Inc., supra,* are quite parallel to the problems confronted in this case, and that decision is the latest expression by the Tax Court on this issue. There the corporate taxpayer owned a chain of newspapers in California and the southwestern part of the United States. Accumulated earnings taxes were assessed for the years 1959 and 1960. The corporation had a net working capital in 1959 of $3,229,-222.00, with a ratio of current assets to current liabilities of 4.28 to 1. In 1960 it had a working capital of $3,803,-864.00, with a ratio of current assets to current liabilities of 5.81 to 1. The taxpayer took the position that its accumulated earnings in the years in question were required in carrying out its expansion plans of acquiring additional newspapers and as a cushion for possible anti-trust liability. While the Commissioner recognized the propriety of retaining earnings for the expansion of a corporation's business under Section 1.537-2(b) of Treasury Regulations, it urged that the taxpayer had no "specific and definite plans" to use the accumulation for its

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Sterling Distributors, Inc. v. United States, 313 F.2d 803(11 AFTR2d 767) (C.A. 5, 1963), *Breitfeller Sales, Inc., supra; James M. Pierce Corporation, supra.* The other rule of thumb sometimes resorted to states that an accumulation of earnings to meet operating expenses for at least one year is reasonable. *F. E. Watkins Motor Co., supra; J. L. Goodman Furniture Co., supra; James M. Pierce Corporation, supra.* However, it has been said that working capital requirements of one business are not necessarily the same as another business and that therefore the rule of thumb should not be given any greater weight than a rule of administrative convenience. *Dixie, Inc. v. Commissioner,* 277 F.2d 526 (5 AFTR 2d 1239) (C.A. 2, 1960), affirming 31 T.C. 415 (1958), *certiorari* denied 364 U.S. 827 (1960); *Barrow Manufacturing Company v. Commissioner,* 294 F.2d 79 (8 AFTR2d 5330) (C.A. 5, 1961), affirming a memorandum opinion of this court, *certiorari* denied 369 U.S. 817 (1962)." (44 P.H.-T.C. 338, 420)

expansion needs. See footnote for Tax Court's answer in holding that the accumulation of earnings was not beyond the reasonable need of the business.[5]

It will be further noted from *Freedom Newspapers, Inc., supra,* that, while there were no loans to its stockholders, the corporation paid no dividends at any time and liberal salaries were paid to the principal shareholders and officers. As has been stated by the Court of Appeals for the Second Circuit in the *Electric Regulator Corporation* case, *supra,* the economic growth and welfare of a corporation should be a factor to be considered in determining whether there should be an assessment of the accumulated earnings tax.

If appellant is to remain alive and continue its lumber manufacturing operations, it must have a definite and steady supply of raw materials in the form of logs or timber suitable for its mill. While sales of federal timber and a large part of the present sales of state timber are on a "pay-as-you-go" basis, still there are sales of both state and private timber which come up from time to

5. "In two recent cases, *John P. Scripps Newspapers, supra,* and *Bremerton Sun Publishing Co.,* 44 T.C. 566 (1965), this court has recognized that the 'definite and certain' requirements with respect to plans of expansion must be analyzed in the context of the particular business involved. Therefore, the specificity of petitioner's plans for expansion must be judged in the light of the problems common to the newspaper business and the acquisition of newspapers. These problems are in a sense unique. A newspaper in no way resembles a fungible commodity. A prospective customer cannot merely place an order or draw plans, as for a piece of machinery or additional construction. He can do no more than actively search out opportunities for acquisition, either personally or through brokers. However, there is no assurance that his investigation and negotiations will culminate in an acquisition of any particular newspaper in any particular month or year." (P.H.-T.C. Memo, 1965—248 at 1465)

time on a lump sum cash basis (Ex. 2). Good business practice should dictate that the appellant have on hand at all times ample cash reserves to purchase all timber available at such sales which is suitable for appellant's mill and which can be manufactured into lumber at a profit. Certainly, the appellant should not be expected to obtain bank loans and incur interest charges in order to make such purchases. If the Company is unable to invest its cash reserves in the profitable purchase of logs and timber inventories, the high ratio between current assets and current liabilities will continue and in any year that the corporaton earns net profits it will be exposed to the accumulated earnings tax on the strength of the lower court's decision if the same is affirmed. It should be noted here that the net operating loss carrybacks and carryovers under the 1954 Code are not deductible for the purpose of computing accumulated taxable income under Section 535(b)(4). Certainly there is little incentive for small mills, without permanent stands of timber, to continue operating in a competitive industry if any future earnings or profits may be subjected to this penalty tax. A sensible answer would seem to be a dissolution of the corporation and a distribution of its assets to shareholders while it still enjoys a highly liquid position. Such a termination of the Company with the resultant loss of a substantial payroll to the area and potential loss of income tax revenue would be directly contrary to the decision and rationale of the *Electric Regulator Corporation* case.

III.

Supply of Logs Obtainable on Open Market, Together With Logs Produced From Possible Purchases of State and Federal Timber on Installment Basis Is Not Sufficient to Permit Expansion or a Continued Profitable Operation by Appellant

Commencing on page 32 of its brief, under the subtitle, "Mill requirement of logs and timber," the appellee argues that the logs available on the open market, together with those produced from timber which can be purchased at sales of state and federal timber on an installment basis are adequate to fulfill the appellant's log requirements. Again, on page 35 of appellee's brief, it is stated, "The December 31, 1959, holdings of logs and timber were in excess of . . . (taxpayer's) one year's capacity for the production of timber (I.R. 185). Taxpayer does not challenge this finding; nor can it do so on the record."

On page 23 of its brief the appellee admits that appellant required from 22 million to 25 million feet of logs each year, and that, as a well-known producer of certain specialty items for which there was a constant demand, it looked primarily to Douglas fir as the source of supply for the manufacture of such specialty items.

The following schedule of purchases of all federal and state timber from 1958 through 1963 has been prepared from the factual data set forth in Exhibit 2, based on federal and state estimates, all of which were made on an installment basis with the exception of the 1958 pur-

chase known as "Sale No. 966" (Greenwater) which was made on a non-scale lump sum cash basis of $531,000.00 and which, among other things, shows the ratio between the Douglas fir and hemlock and related species covered by such sales:

Description of Sale	*Date of Purchase*	*Total Volume Ft. B.M.*	*Volume Douglas Fir Ft. B.M.*	*Pg. Rec. Ex. 2*
	1958			
No. 966 (Greenwater)	8/25/58	11,341,000	8,555,000	4
	1959			
Berry Creek No. 3	12/23/59	19,400,000	3,300,000*	11
	1960			
Rocky Run	4/19/60	11,806,000	4,795,000	5
Rocky Brook Ridge	9/28/60	11,200,000	6,900,000*	12
Upper Rocky Brook	12/28/60	2,900,000	1,700,000*	12-13
	1961			
Hazzard Creek	12/28/61	9,500,000	5,000,000	13
	1962			
Rock Run Blow Down	6/25/62	3,244,000	1,082,000	5-6
Mud Lake	8/27/62	1,194,000	818,000	6
East Valley Sale	12/26/62	12,300,000	5,400,000	14
	1963			
Gut Mountain	5/27/63	8,016,000	1,977,000	7
Lower Greenwater	12/30/63	5,860,000	4,200,000	15

*Estimate includes western white pine with undetermined volume.

In connection with the foregoing schedule, reference should be made to Exhibit 13 which shows the undercut and overcut on seven out of the total of eleven purchases covered. Mr. Sambila, who is employed by appellant as a timber purchaser, testified that at the time of trial in sales of federal timber by the U. S. Forest Service "that the remaining stands of timber comprised 20 per cent Douglas fir and the remaining in white fir, Noble fir and hemlock" (R. Tr. 201).

Profits on the sale of lumber manufactured from hemlock and related species of timber are much lower than those realized on the specialty items manufactured by appellant from high-grade Douglas fir logs and, in many instances, are marginal (Dep. 30). As a matter of fact, in some instances the market price of hemlock lumber has been less than the price of hemlock logs sold for Japanese export (R. Tr. 31).

R. L. Dickman, Sr., who did not appear as a witness at the trial but whose testimony is a part of the record in deposition form, stated in response to the question with respect to his opinion on any maximum limitation on volume or amount of timber that should be acquired by appellant, as follows:

> "Well, under those conditions we would naturally pick up all that we could that would be the kind that we could use in our mill. * * * but we would bid on all timber that we can that fits our mill." (Dep. 28).

Donald H. Doud stated in his affidavit (portion ad-

mitted by appellee) "that a sawmill of the same capacity and type of plaintiff's sawmill, if it is to continue operating, should acquire all timber that it can purchase within its means, if such timber can be purchased at a price which would permit it to be profitably logged and manufactured into lumber" (R. 167, 168).

The appellee on page 37 and page 38 of its brief, states "that the opinion of the taxpayer's officers and directors as to the purchase of timber at any price, hardly consists of a plan sufficiently specific and definite to justify the retention of the 1959 earnings." On this point we would direct the Court's attention to pages 37 and 38 of appellant's brief which enumerates the purchases of privately owned timber and state timber purchased on a non-scale lump sum cash basis for amounts as high as $1,175,645.00. We would specifically direct the Court's attention to the bid made on June 8, 1959, by appellant on a tract of state timber known as "Sale No. 970" on a non-scale cash lump sum basis in which its cash bid of $510,000.00 was rejected and the timber sold to one of appellant's competitors on a high bid of $697,700.00 (Ex. 2, p. 5). From an examination of this rejected bid it will be noted that the total volume of timber covered by the sale was 14,122,000 feet B.M., of which 8,942,000 feet B.M. consisted of Douglas fir which would have been suitable for the specialty production at appellant's mill. With respect to the statement of appellee on page 35 of its brief, "the appellant's holdings of logs and timber at the end of 1959 were in

excess of a one year's capacity for production of timber," reference should be made to appellee's Exhibit C which is entitled "Schedule of Investment Balance for Timber" (including road construction costs) and covers that period from December 31, 1959 to December 31, 1963. A breakdown of the timber inventory as of December 31, 1959, as shown by Exhibit C, is as follows:

Name of Timber Site	*Investment Balance at 12/31/59*
Jefferson County	$ 36,277.90
Denny Claims	35,000.00
Fernandez	468,305.00
Mt. Craig	39,259.37
Mowich Lake Road No. 2	36,000.00
West Tacoma Newsprint	6,333.34
Simpson Co.	48,410.09
Enumclaw (Greenwater)	77,060.02
Berry Creek No. 3	12,000.00

Unfortunately, the foregoing itemized statement of timber inventory was not explained at the trial. However, the appellee has admitted that the Fernandez item of $468,305.00 should be eliminated since no timber was included in this investment. The Mowich Lake Road #2 undoubtedly applied to road costs on timber previously purchased and does not necesarily show timber reserves. The item designated Enumclaw (Greenwater) refers to State Sale No. 966 in which appellant purchased timber for the total cash sum of $531,002.00 in 1958. There is no information in the exhibit which would indicate whether this particular item included remaining timber or the balance of road and other costs of production. Exhibit C further reveals that at the end of 1958

the dollar timber inventory, exclusive of the Greenwater tract, was limited to the sum of $67,459.81, only a portion of which constituted Douglas fir.

With respect to the log inventory at the end of 1959, Exhibit 4 shows a total log volume of 4,559,760 feet B.M. There is no evidence as to what portion of this log inventory constituted hemlock and related species and what portion constituted Douglas fir suitable for appellant's mill. Mr. R. L. Dickman, Sr., testified on deposition that Douglas fir peelers and high-grade fir sawlogs suitable for appellant's operation could not be purchased on the open market (Dep. 29, 30). William L. Burgess who is a Forester for the Internal Revenue Service and who testified as an expert on behalf of the appellee, stated that logs were difficult to buy even prior to 1956 (R. Tr. 226). In conclusion on this problem, we again refer to the language in *John P. Scripps Newspaper, supra,* and *Bremerton Sun Publishing Co., supra,* which is quoted in the footnote at the bottom of page 15 of this brief, in which it is stated that a newspaper in no way resembles a fungible commodity and a prospective customer cannot merely place an order or draw plans as for a piece of machinery or additional construction, but can do no more than actively search for opportunities for acquisition. The same principle holds true with respect to the availability of logs and timber suitable for appellant's mill which can be obtained in the area in which it is located. We also would refer to the recent Tax Court decision in *Bardahl Manufacturing Co.,* (Filed

7/23/65), T. C. Memo 1965-200, where it was held that an accumulation of earnings for the acquirement and stockpiling of an ingredient of its gasoline additive which was scarce or unobtainable due to an emergency, was a reasonable business need.

IV.

1959 Earnings Properly Accumulated for Retirement of Stock Under Section 303

On this phase of the matter, the appellant would again direct the Court's attention to the lack of cash or liquid assets owned by the principal stockholders of appellant, namely, R. L. Dickman, Sr. and the decedent, Lydia L. Dickman, with which to pay federal estate and state inheritance taxes and the costs and expenses of administration. As pointed out in appellant's opening brief, the total appraised valuation of the community estate of R. L. Dickman, Sr. and the decedent in round figures totalled the sum of $1,594,000. Of this amount, $1,400,000 covered the appraised value of the 4,000 shares of stock of appellant corporation. The balance of the estate assets, having a total appraised valuation in the approximate sum of $194,000.00 consisted of a dwelling house, furniture and art objects situated in the dwelling house, together with certain miscellaneous shares of stock, a portion of which is unlisted, with a total appraised valuation of $70,000.00 (Ex. 11).

In response to the arguments of appellant contained on page 54 of its brief with respect to the dire results which would follow if "a fund could be established to pay the estate taxes of each of the stockholders of the

corporation through a future stock redemption," we would direct the Court's attention to those provisions of Section 303 which limit the retirement of stock for the payment of taxes and costs of administration to those situations where the stock in question constitutes either 50% of the decedent's gross estate, or 35% of the decedent's net estate.

On this whole problem we would refer the Court to the article entitled "Stock Redemption and the Accumulated Earnings Tax" by Professor David H. Herwitz, which is set forth in Volume 74, No. 5 of the Harvard Law Review dated March 9, 1961.

As noted by Professor Herwitz, the "*Mountain State* case 284 F.2d 757 (4th Cir. 1960) appears to have placed its stamp of approval upon the business-purpose analysis of redemption transactions under the accumulated earnings tax." 74 Harv. L. Rev. 866, 918 (1961). The Fourth Circuit Court of Appeals found persuasive the reasoning of *Emeloid Co. v. Commissioner*, (C.A. 3, 1951) 189 F.2d 230 where the Court there held that a corporate business purpose was served by corporate disbursements to pay insurance premiums to provide a fund with which to purchase stock from the estate of a deceased shareholder pursuant to a stock restriction agreement.

See, also, *Fred F. Fisher*, 6 CCH Tax Ct. Memo 520 (1947), where redemption of stock from taxpayer's sister in order to restore harmony constituted a business pur-

pose so as not to be a constructive dividend, c.f. *Gazette Publishing Co. v. Self*, 103 F. Supp. 779 (E.D.Ark. 1952), and Mertens, Law of Federal Income Taxation § 39.35.

V.

Appellant's Evidence Overcame Presumption of Prescribed Purpose

On page 17 of its brief the appellee states that appellant "makes no independent contention that it proved by a preponderance of the evidence that such accumulations—reasonable or otherwise—were not for the purpose of avoiding income tax on it shareholders. On page 20 appellee sets forth as an applicable legal principle that the appellant must not only show under objective standards that the earnings retained were for the reasonable needs of its business, but also carry the burden of proving its actual intent. Section 533(a) of the Code provides in effect that proof of accumulations beyond the reasonable business needs of any corporation is determinative of the purpose "unless the corporation by the preponderance of the evidence shall prove to the contrary."

Paragraph II of the Statement of Points to be relied upon by appellant, which was filed by appellant with the Clerk of the Circuit Court of Appeals in compliance with the Ninth Circuit Rules, reads as follows:

> "That the District Court erred in finding and concluding that the appellant had for its purpose accumulated earnings and profits in the avoidance of income tax on its shareholders."

In its opening brief under the subtitle "Questions Presented," it was stated that one of the questions raised was whether "earnings and surplus had been accumulated for the purpose of avoiding surtax upon the shareholders" of appellant. Appellee relies principally on the three following grounds in arguing that the appellant has not overcome the presumption of the prescibed purpose. First, if the sum of $129,000.00 had been distributed as dividends in 1959, there would have been an increased surtax liability on the shareholders of $87,000.00. Second, the amounts advanced to or for the benefit of the Dickmans at the end of the years 1958 through 1963, as shown on page 12 of appellee's brief, tends to show the prescribed intent; and third, it is urged that the accumulation for the retirement of stock under Section 303 was personal to the shareholders and served no corporate purpose.

In examining the other side of the coin from the appellant's standpoint, the following matters show a lack of intent and constitute evidence overcoming the presumption of the prescribed purpose. First, the noninterest bearing loans to the Dickman family at the end of 1959 were limited to the sum of $9,192.00 which is minimal in view of the large accumulations of surplus and earnings. Second, there were no investments at any time in unrelated businesses. Third, there was no intent to liquidate the corporation as shown by the testimony of R. L. Dickman, Sr. (Dep. 42) which is borne out by the admitted evidence of the investments made in 1960 and

1961 as planned in 1959, covering plant modernization and improvements. Fourth, the appellant's income tax returns were audited each year from 1951 through 1963, and although the ratio of current assets to current liabilities in 1956 and 1957 exceeded the 1959 ratio of 9 to 1, the accumulated earnings tax had never been assessed against appellant. In 1956 the current assets of $1,376,143.00 bore a ratio to the current liabilities of $62,449.00 in excess of 22 to 1. In 1957 the current assets of $1,598,332.37 had a ratio to current liabilities of $33,239.00 in excess of 48 to 1 (R. Tr. 206-211; Ex. 8). It will be further noted from Exhibit 8 that even in the year 1955 with current assets of $1,568,349.00 and current liabilities of $215,698.00, that the ratio of current assets to current liabilities was 7.63 to 1. The Fernandez transaction did not occur until the latter part of 1956 and the resultant loss was not fully known until after the judgment was entered against Fernandez late in 1958. With the foregoing experience from the previous audits which had not resulted in accumulated earnings tax assessments, and with the knowledge of the decision in the *Defiance Lumber Co.*, T. C. Memo Op. Dkt. 84067 (1953), which has been fully discussed in appellant's opening brief, the officers were justified and were honest in their belief that they could accumulate earnings of appellant for the reasonable needs of the business, including the purchase of logs and timber suitable for appellant's mill.

The accumulation of earnings in 1959 was for the

avowed purpose as testified to by appellant's officers (Dep. 39-40; R. Tr. 70, 71) of meeting the reasonably anticipated needs of appellant's business, consisting of hazards of the business, working capital required for the purchase of logs and timber suitable for appellant's mill which could be manufactured into lumber at a profit, the cost of modernization and improvements of mill, and amounts required for retirement of stock under Section 303.

In *Bremerton Sun Publishing, supra,* the Tax Court held that even though there was an accumulation of earnings beyond the reasonable needs of the business, there was no wrongful purpose—namely, an intent to avoid a dividend tax to the shareholders. This lack of intent was based largely on the showing of a history of substantial dividends, no loans to shareholders, and no investments in unrelated businesses. The years involved were 1958 and 1959. In 1958 the taxpayer's current assets amounted to the sum of $639,064.86, and its current liabilities amounted to $165,788.68. In 1959 its current assets amounted to the sum of $594,741.40, and its current liabilities $153,897.09. The Tax Court's ruling that the corporation was not availed of in the avoidance of income tax on the shareholders was grounded on the conservative fiscal policy of the newspaper's directors. Language from the decision is quoted in the footnote.[6]

6. "These factors are strong indications that the accumulations were not for the proscribed purpose, Section 1.533-1(a)(2), Income Tax Regs. Furthermore, there is no doubt that a good history of dividends, the absence of loans to the sole shareholder, the absence of investments in unrelated businesses, and the paying of a large salary to the sole shareholder indicate that the accumulation of earnings and profits was

CONCLUSION

In conclusion, it is urged that the entire record should be reviewed, and that all reasons relied on by appellant for the 1959 accumulation of earnings should be considered collectively and not piecemeal and separately, or on the theory of "divide and conquer," the obvious strategy adopted by appellee in its brief, and the trial court's decision should be reversed because it is clearly erroneous.

In the alternative it is further urged that if this Court on the entire evidence is left with a definite and firm conviction that a mistake has not been committed, and that the decision of the District Court should not be reversed and judgment entered in favor of appellant, then the case should be remanded to the District Court with instructions to make additional and specific findings on all admitted and undisputed evidence in compliance with Rule 52(a) or in the third alternative, that the appellant be granted a new trial.

Respectfully submitted,

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for legitimate business needs. *James M. Pierce Corporation, supra; Gazette Pub. Co. v. Self, supra.* We point this out because it is apparent to us that although the directors of petitioner did accumulate too much surplus, they did so thinking it was necessary for the business needs and not because of any desire to avoid the surtax on its sole shareholder. It must be remembered that the gist of the statutory violation is the intent to use the corporation to avoid surtax on its shareholder and not whether the decision to accumulate the income was wisely made. *KOMA, Inc. v. Commissioner,* 189 F.2d 390, 396 (40 AFTR 712) (C.A. 10, 1951) affirming a Memorandum Opinion of this Court." (44 P.H.-T.C. 421)

CERTIFICATE OF COMPLIANCE

I certify that, in connection with the preparation of this reply brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit and that, in my opinion, the foregoing brief is in full compliance with those rules.

OWEN P. HUGHES
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